

PORTFOLIO STRATEGIES

Withdrawal Strategies to Make Your Nest Egg Last Longer

By William Reichenstein

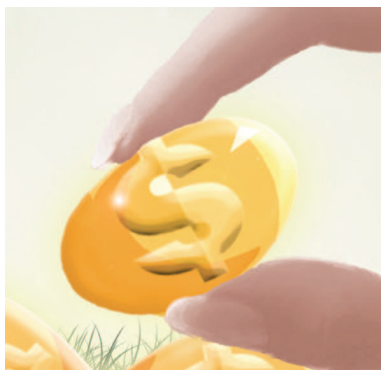
In a series of three articles in 2005, I established three principles for tax-efficient investing.

- When saving for retirement, individuals should maximize contributions to Roth IRA and qualified retirement accounts like the 401(k). (See “Tax-Efficient Investing and What It Means to Your Portfolio” in the February 2005 *AII Journal*.)
- When managing stocks in taxable accounts, individuals should aggressively realize capital losses (that are large enough to offset transaction costs) and hold onto unrealized gains. (See “The Great Tax Fight: Managing Stocks in Taxable Accounts” in the July 2005 *AII Journal*.)
- In terms of locating assets between taxable accounts and retirement accounts, when possible while attaining the desired asset allocation, individuals should place bond holdings in retirement accounts and stocks, especially passively held stocks, in taxable accounts (with the exception of liquidity reserves and tax-free municipals, which should be held in taxable accounts). (See “Tax-Efficient Investing: Picking the Right Pocket for Your Assets” in the November 2005 *AII Journal*.)

These principles guide individuals who are accumulating assets for retirement.

But what about individuals who are in retirement withdrawing assets?

This article guides individuals who are withdrawing assets in their golden years and builds on my recent study for the TIAA-CREF Institute (www.tiaa-crefinstitute.org/research/trends). It is designed to answer questions such as: In order



to maximize a portfolio's longevity—i.e., the length of time before it runs out of funds—should a retiree withdraw funds from his taxable account followed by the Roth IRA and then the 401(k) or would another sequence be preferred? Should the retiree withdraw funds from a Roth IRA and leave funds in the 401(k) for a beneficiary, or vice versa? [For a related article on withdrawal strategies for individuals primarily invested in mutual funds, see the article “Developing a Withdrawal Strategy for Your Fund Portfolio,” starting on page 13 in this issue.]

Withdrawal Strategies to Maximize Portfolio Longevity

In this section, I consider the impact of alternative withdrawal strategies on a portfolio's longevity. Here, I assume that the retiree's goal is to adapt the withdrawal strategy that will maximize the portfolio's longevity, and therefore I (at least initially) assume the retiree is not concerned about the amount of funds that will be left for beneficiaries.

Effective Tax Rates

This section's key principle is that effective tax rates are higher on taxable accounts than on retirement accounts, where retirement accounts include the Roth IRA and qualified accounts such as the 401(k). Therefore, as a rule of thumb, retirees should withdraw funds from taxable accounts before retirement accounts.

Let's consider effective tax rates on taxable bonds and stocks held in each of three savings vehicles: taxable

Roth IRA Effective Tax Rates: An Example

Assume a retiree has \$100 in a 401(k) and \$85 in a Roth IRA and she will be in the 15% ordinary income tax bracket when she withdraws funds. If invested in the same asset, the \$100 in a 401(k) is like \$85 in a Roth IRA because they will each buy the same amount of goods and services. It is useful to mentally separate today's \$100 pretax balance in the 401(k) into \$85 of the investor's aftertax funds and \$15 of the government's share of the current principal. Generalizing, it is useful to think of the individual as owning (1-t) of the 401(k)'s current principal and the government as "owning" the other t of current principal. In other words, if the withdrawal tax rate will be "t," then each dollar of pretax funds currently in a qualified account is like (1-t) dollar of aftertax funds currently in a Roth IRA.

Since funds in the Roth IRA grow tax exempt, the aftertax value of funds in the qualified account grows tax exempt too. For example, suppose the 401(k) and Roth IRA are invested in the same asset and it has a 100% cumulative return before distribution. The \$85 in the Roth would be worth \$170 after taxes. The \$100 in the 401(k) would be worth \$200 pretax, but \$170 after taxes. Generalizing, the 401(k)'s aftertax value grows from \$85 today to $\$85(1+r)^n$, where r is the pretax rate of return and n is the length of the investment horizon. Similarly, the aftertax value of the Roth IRA grows from \$85 today to $\$85(1+r)^n$.

accounts, Roth IRAs, and qualified accounts (which include traditional IRA, 401(k), 403(b), 457, SEP-IRA, SIMPLE and Keogh plans).

We will consider lower-wealth retirees who will be in the 15% ordinary income and 5% capital gains tax brackets, and higher-wealth retirees who will be in the 25% ordinary income and 15% capital gains brackets.

Many individuals will be in higher tax brackets, especially when state taxes are considered. As will become clear, the withdrawal sequence should be even more important to these investors.

Table 1 presents the lower-wealth and higher-wealth retirees' effective tax rates on bonds and stocks held in each of three savings vehicles.

When held in a taxable account, individuals pay taxes each year on bonds' interest income at the ordinary income tax rate. Since capital gains tend to be negligible on bonds, the effective tax rate on bonds held in taxable accounts is 15% for the lower-wealth couple and 25% for the higher-wealth couple.

The effective tax rate on

stocks held in taxable accounts depends, in part, on when and whether the investor realizes capital gains. For purposes of this study, we consider two types of stock investors:

- The relatively few who will avoid taxes on capital gains by either awaiting the step-up in basis at death or giving the appreciated stocks to charity, and
- The vast majority who will pay taxes on capital gains.

For the first group—the exempt investors—the effective tax rate on stocks held in taxable accounts is close to zero; they would still owe taxes on dividends,

but today's dividend yields are so low that their effective tax rate would be close to zero.

Let's call the larger group "typical" investors. For now, let's assume these typical investors realize all gains each year—technically in one year and one day. They pay taxes each year on qualified dividends and capital gains at the long-term capital gains rate. The effective tax rate for the lower-wealth couple is 5% and the effective rate for the higher-wealth couple is 15%. Later, we will consider typical investors who will allow gains to grow unrealized for several years.

The effective tax rate on bonds and stocks held in a Roth IRA is zero. The funds grow tax exempt (assuming the withdrawal occurs after age 59½). As explained in my February 2005 article, the aftertax value of funds held in a qualified account also grow effectively tax exempt; the effective tax rate is zero. [The examples in the accompanying box help clarify this important point.]

Table 1 summarizes the effective tax rates for a lower-wealth and higher-wealth retired couples who are typical stock investors. Since they pay higher effective tax rates on assets held in taxable accounts, they should withdraw funds from taxable accounts before retirement accounts.

Strategies and Longevity

The intuition from Table 1 is

Table 1. Effective Tax Rates on Assets in Taxable Accounts, Roth IRAs, and Qualified Accounts

	Lower-Wealth Retirees		Higher-Wealth Retirees	
	Bonds	Stocks	Bonds	Stocks
Taxable Accounts	15%	5%	25%	15%
Roth IRAs	0%	0%	0%	0%
Qualified Accounts	0%	0%	0%	0%

Qualified accounts include traditional IRA, 401(k), 403(b), 457, SEP-IRA, SIMPLE and Keogh plans.

that a strategy of withdrawing funds from taxable accounts before retirement accounts should allow the portfolio to last longer than a strategy of withdrawing funds from retirement accounts before taxable accounts. This section is designed to provide insights into the additional longevity from following this preferred strategy.

To estimate the additional longevity, I developed detailed models that I believe provide reasonable estimates of the additional longevity provided by withdrawing funds from taxable accounts first. In addition, they provide insights about when retirees should deviate from this rule of thumb.

The models provide insight into the likely additional portfolio longevity from the strategy of withdrawing funds from taxable accounts before retirement accounts (which I will refer to as the Taxable Accounts First strategy). The models are designed to be forward-looking. They use key features of today's tax code including the 2005 tax brackets, and assume future bond returns that are consistent with current yields. Of course, stock returns are more difficult to predict.

To provide some range of possible returns, I assumed the next 30 years will repeat either 1973–2002 returns on the S&P 500—which I will refer to as the “poor returns sequence”—or 1976–2005 returns (the “good returns sequence”). Due to the 1973–1974 stock losses, which were similar to 2000–2002 inflation-adjusted losses on the S&P 500, the 1973–2002 period proved especially difficult for retirees. Withdrawal

rate studies generally conclude that individuals who began retirement in 1973 were able to withdraw the least amount from their portfolios and still have their portfolios last a given number of years. Thus, I intentionally chose to use this poor returns sequence. But I also used the good returns sequence.

There are separate models for lower-wealth and higher-wealth retired couples. Each couple is 66 years old.

The lower-wealth couple has a \$1 million aftertax portfolio consisting of \$100,000 in a Roth IRA, \$300,000 in taxable accounts, and \$600,000 of aftertax funds in a 401(k). Based on today's tax code, they will usually be in the 15% ordinary income tax bracket and 5% capital gains bracket during retirement. So the \$600,000 of aftertax funds in the 401(k) is equivalent to \$705,882 of pretax funds [$\$600,000 / (1 - 0.15)$].

The higher-wealth couple has a \$2 million aftertax portfolio consisting of \$0.2 million in Roth IRA, \$1 million of aftertax funds in a 401(k), and \$0.8 million in taxable accounts.

Each couple's objective is to withdraw the largest constant real (or inflation-adjusted) amount each year such that the portfolio lasts 30 years.

Although their joint life expectancy is less than 30 years, they plan for a 30-year horizon to provide reasonable assurance that their portfolio will last throughout their lives.

I modeled two withdrawal strategies:

- **The Taxable Accounts First Strategy:** In this strategy, the couple withdraws funds in the following order: 1) required minimum distributions (RMDs), when applicable, from qualified accounts; 2) bonds and then stocks held in taxable accounts; 3) stocks and then bonds held in Roth IRAs; and 4) stocks and then bonds held in qualified accounts.
- **The Retirement Accounts First Strategy:** In this strategy, the couple withdraws funds in the following order: 1) RMDs, when applicable, from qualified accounts; 2) stocks and then bonds held in Roth IRAs; 3) stocks and then bonds held in qualified accounts; and 4) bonds and then stocks held in taxable accounts.

Required minimum distributions are assumed to begin when the couple is age 70. Adopting the asset-location

Table 2. Additional Longevity From Taxable Accounts First Strategy Compared to Retirement Accounts First Strategy

Lower-Wealth Retirees				
Returns Sequence	Initial Withdrawal (\$)	Portfolio Longevities (No. of Years)		
		Taxable Accounts First	Retirement Accounts First	Additional Longevity
Poor	34,949	30.0	27.7	2.3
Good	48,908	30.0	27.6	2.4
Poor	50,000	16.5	16.0	0.5
Good	50,000	28.6	26.5	2.1
Higher-Wealth Retirees				
Returns Sequence	Initial Withdrawal (\$)	Portfolio Longevities (No. of Years)		
		Taxable Accounts First	Retirement Accounts First	Additional Longevity
Poor	73,364	30.0	24.6	5.4
Good	98,734	30.0	24.7	5.3
Poor	100,000	17.4	16.2	1.2
Good	100,000	29.3	24.1	5.2

Table 3. Largest Sustainable Initial Aftertax Withdrawal Rates by Portfolio Longevity and Time Period

Returns Sequence	Portfolio Longevity	
	20-Year	30-Year
Poor	4.4%	3.5%
Good	6.0%	4.9%

These sustainable initial withdrawal rates are for the lower-wealth retired couple. The initial withdrawal rate is the first-year withdrawal as a percentage of the first-year total portfolio value. Subsequent withdrawals are the first-year dollar amount increased by inflation.

advice I gave in my November 2005 article, I assumed stocks were held in taxable accounts and (non-municipal) bonds in retirement accounts to the degree possible while attaining the 50% stocks/50% bonds target asset allocation.

After each beginning-of-year distribution, the portfolios were rebalanced back to a 50% stocks/50% bonds aftertax asset allocation. Thus differences in longevity are due to differences in effective tax rate, and not to differences in asset allocation. (For other model details, see the sidebar on page 10.)

Table 2 presents results for both couples and the two 30-year returns sequences.

First, let's consider the lower-wealth couple. With the poor returns sequence, if this couple followed the Taxable Accounts First strategy, it could withdraw \$34,949 in 2005, the first retirement year, and an inflation-adjusted equivalent amount each year thereafter, and the portfolio would last precisely 30 years. If they withdrew the same amount using the Retirement Accounts First strategy, the portfolio would last 27.7 years. Therefore, the portfolio's longevity was 2.3 years longer with the Taxable Accounts First strategy.

With the good returns sequence, if this couple followed the Taxable Accounts First strategy instead of the Retirement Accounts First strategy the portfolio would last 2.4 years longer.

The longevity advantage is generally shorter when the initial withdrawal is larger. For example, if the initial withdrawal is \$50,000 then the additional longevity from the Taxable Accounts First strategy is 0.5 years for the poor

returns sequence and 2.1 years for the good returns sequence.

In sum, the lower-wealth couple may be able to lengthen the portfolio's longevity by perhaps two years by following the Taxable Accounts First strategy instead of the Retirement Accounts First strategy.

The higher-wealth couple pays higher effective tax rates on bonds and stock held in taxable accounts. Therefore, it follows that the additional portfolio longevity from following the Taxable Accounts First strategy should be larger for this couple.

With the poor returns sequence and an initial withdrawal of \$73,364, the Taxable Accounts First strategy lasts 30 years and the Retirement Accounts First strategy lasts 24.6 years. The additional longevity is 5.4 years.

With the good returns sequence and an initial withdrawal of \$98,734, the additional longevity is 5.3 years.

As before, the longevity advantage is generally shorter when the initial withdrawal is larger. For an initial withdrawal of \$100,000, the additional longevity from the Taxable Accounts First strategy is 1.2 years for the poor returns sequence and 5.2 years for the good returns sequence.

In short, due to the higher effective tax rates in taxable accounts, the higher-wealth couple may be able to lengthen the portfolios' longevity by about five years by following the Taxable Accounts First strategy.

The Problem of Uncertainty

Table 3 illustrates the difficult task facing retirees and the importance of

two uncertainties: the length of remaining life, and future returns. For a 30-year lifespan and the poor returns sequence, the portfolio would only support a 3.5% initial withdrawal rate. For a 30-year lifespan and the good returns sequence, the portfolio would support an initial withdrawal rate of 4.9%.

For a 20-year lifespan, the initial withdrawal rates are about 1% higher for both the poor and good returns sequences. These results illustrate the problem facing retirees. Since they do not know how long they will live or whether future stock returns will be strong or weak, the conservative strategy is to plan for a long lifespan and poor returns.

The models confirm the intuition as expressed in the rule of thumb: *In general, retirees should withdraw funds from taxable accounts before retirement accounts.* Moreover, the higher the retiree's effective tax rates on assets held in taxable accounts, the larger is the additional portfolio longevity from following this withdrawal sequence.

Exceptions to Rule of Thumb

This section discusses exceptions to the rule of thumb to withdraw funds from taxable accounts before retirement accounts.

The first exception occurs for retirees who will be in an unusually low tax bracket in the years before required minimum distributions begin.

Required minimum distributions begin after age 70½. Before this time, a retired couple or single retiree who is withdrawing funds from taxable accounts may have minimal "taxable income." ("Taxable income" refers to the tax term. That is, it is adjusted gross income less standard or itemized deductions and other deductions such as for personal exemptions.) Withdrawals from taxable accounts are largely, if not entirely, a return of principal. They provide cash to live on but these transactions usually produce negligible taxable income. Thus, retirees who have quit work and are living off funds withdrawn from taxable accounts will frequently have minimal taxable income

before required minimum distributions begin.

In these usually low tax rate years, retirees should either withdraw sufficient funds from qualified accounts to fully use low tax brackets, or convert sufficient funds from qualified accounts to Roth IRAs to fully use the low brackets.

For example, suppose the lower-wealth couple received \$18,400 of Social Security benefits in 2005 and this was their only income subject to taxes. For this couple, in 2005 the sum of the standard deduction, the two deductions for personal exemptions, plus a \$1,000 deduction each for being over age 65 totaled \$18,400. So, after these deductions, this couple's taxable income may have been zero.

Since the first \$14,000 of taxable income in 2005 was taxed at 10%, this couple should either withdraw \$14,000 from a qualified account or convert \$14,000 from a traditional IRA to a Roth IRA to fully use the 10% tax bracket.

Similarly, the higher-wealth couple should make sure they fully use the 10% and 15% tax brackets. In 2005, the top of the 15% tax bracket was \$59,400 of taxable income. These retirees should not waste the opportunity to withdraw funds from qualified accounts when they would be subject to unusually low tax rates.

A second exception occurs for an exempt investor who will avoid capital gains taxes on appreciated stocks held in taxable accounts. In essence, the effective tax rate on these capital gains is zero, but only if the retiree awaits the step-up in basis at death or donates the appreciated stock to a qualified charity.

To illustrate the logic, assume a single retiree is terminally ill and has a short life expectancy. After his death, his beneficiary will inherit the stock with the cost basis stepped up to the market value at the time of his death. It would be foolish for the retiree to sell the stock and thus pay taxes on the realized capital gains.

Similarly, if he will donate the appreciated stock to a qualified charity, the capital gains taxes will be avoided due

to the charity's tax-exempt status.

In these cases, he should not follow the rule of thumb. Instead, he should obtain funds from other sources including, if necessary, withdrawing funds from retirement accounts. (See my July 2005 article for further discussion of the step-up in basis and charitable donations.)

Suppose a retiree has an appreciated stock that he does not expect to sell for many years. In this case, since the gains will be tax-deferred, the effective tax rate on the gains will be less than the long-term capital gains tax rate. However, the effective tax rate will still be positive. And, intuitively, it is better to withdraw funds from taxable accounts, where returns are taxed at positive effective rates, than to withdraw funds from retirement accounts, where returns grow effectively tax-exempt. Therefore, if a retiree has an appreciated asset on which he expects to eventually pay taxes, he should sell this asset before liquidating retirement accounts.

Withdrawal Strategies From Retirement Accounts

The prior section established the rule of thumb to liquidate taxable assets before retirement assets. This section considers whether retirees should withdraw funds from Roth IRAs before qualified accounts, or vice versa.

The key principle in the prior section is that effective tax rates are higher on taxable accounts than on retirement accounts. Therefore, as a rule of thumb, retirees should withdraw funds from taxable accounts before retirement accounts.

However, the key principle in this section is that the investor effectively owns $(1-t)$ of a qualified account's principal, while the government "owns" the other t of principal, where t is the tax rate when the funds are withdrawn in retirement. The idea is to minimize t , the government's share of the qualified account's principal.

To minimize the government's share of the qualified account's principal, funds should be withdrawn from qualified accounts whenever the retiree

is in an unusually low tax bracket.

Three situations where taxable income might be unusually low include:

- 1) Years before required minimum distributions begin (as discussed previously),
- 2) Years with large charitable contributions, and
- 3) Years with large deductible medical expenses.

Suppose a retiree makes a large charitable contribution out of taxable accounts. This contribution would increase itemized deductions (subject to income limits affecting the maximum deductible contribution), which may result in a low level of taxable income.

Separately, the recent pension legislation allows an opportunity for individuals over age 70½ to donate funds out of qualified accounts. For tax years 2006 and 2007, individuals over 70½ can move up to \$100,000 out of their traditional IRAs directly to a qualified charity. This donation would not affect their taxable income, and the \$100,000 would count toward that year's required minimum distribution.

Finally, retirees may be in a low tax rate in a year that they have large deductible medical expenses. Medical expenses are deductible to the degree that they exceed 7.5% of adjusted gross income. Medical expenses may include all costs associated with full nursing home care and many costs associated with assisted living and independent living arrangements. It is often difficult for a retiree to predict whether she will have large medical expenses, since these expenses tend to occur late in life. Nevertheless, retirees who suspect that they will have large medical expenses might save qualified accounts for those years.

Retiree's vs. Beneficiary's Tax Rates

One additional consideration for a retiree who wants to bequeath funds is the relationship between the tax rates of the retiree and beneficiary. Everything else the same, if the retiree has a higher tax rate than the beneficiary, she should withdraw funds from the Roth IRA and leave funds from the qualified account for the beneficiary.

The Models' Assumptions

The objective of the models used to generate the tables in this article is to estimate how much longer retirees' portfolios might last if they withdraw funds from taxable accounts before retirement accounts instead of the opposite strategy. That is, what is the additional portfolio longevity from following the Taxable Accounts First strategy instead of the Retirement Accounts First strategy?

To answer this question, I modeled key features of the 2005 tax code and potential future returns on taxable bonds and stocks.

I calculated the largest real (i.e., inflation-adjusted) aftertax withdrawal that the couple could make each year following the Taxable Accounts First strategy and still have the portfolio survive for 30 years.

I then calculated the portfolio's longevity for this annual withdrawal amount when following the Retirement Accounts First strategy.

The difference is an estimate of the additional longevity from following the Taxable Accounts First strategy.

The models assume the retired couple has no earned income (e.g., wages and salaries) during retirement. The couple makes minimum required distributions from qualified accounts each year, and the first required distribution occurs in the calendar year the couple turns 70. Additional distributions to attain their annual aftertax withdrawal amount come from taxable accounts or retirement accounts, where the latter may include additional withdrawals from qualified accounts. Their taxable income consists of all distributions from qualified accounts.

One way to view the models is to implicitly assume that the couple's Social Security income was \$18,400 in 2005, the first year of retirement. In 2005, \$18,400 was also the sum of the standard deduction, the two deductions for personal exemptions, plus deductions of \$1,000 each for being over 65. Since Social Security income was just offset by this sum of deductions, the couple's taxable income consists of withdrawals from qualified accounts. If Social Security payments and the deductions increase with inflation each year, then taxable income always consists of withdrawals from qualified accounts.

Gross bond returns are assumed to be 5%, which is consistent with long-term Treasury yields in most of 2006. Of course, gross stock returns are more difficult to predict. To provide some range of possible returns, I

assumed the next 30 years will repeat either 1973–2002 returns on the S&P 500—a poor returns sequence—or 1976–2005 returns—a good returns sequence.

Net bond and stock returns are set 1% per year lower than the gross returns to reflect mutual funds' expense ratios and transaction costs. For simplicity, the models assume all capital gains and losses are realized each year—technically, in one year and one day. So all stock returns are taxable each year at the long-term gains tax rate. Consistent with mutual fund distribution requirements, the models assume net losses cannot be passed through to investors, but are accumulated and used to offset future capital gains. Taxes on net realized capital gains are paid each year.

The models assume the first withdrawal in retirement occurs in 2005. In 2005, the first \$14,000 of taxable income is taxed at 10%, taxable income up to \$59,400 is taxed at 15%, and so on. These brackets were increased each year with inflation as measured by the consumer price index. Adopting the asset-location advice I gave in my November 2005 article, I assumed stocks were held in my taxable accounts and bonds in retirement accounts to the degree possible while attaining the 50% stocks/50% bonds target asset allocation. After each beginning-of-year distribution, the portfolios were rebalanced back to a 50% stocks/50% bonds aftertax asset allocation.

In the base case, the 66-year-old retired couple has a \$1 million aftertax portfolio. They have \$100,000 in a Roth IRA, \$300,000 in taxable accounts, and \$600,000 of aftertax funds in a 401(k). Assuming stock returns and inflation rates will repeat the poor sequence, the portfolio would support an aftertax withdrawal of \$34,949 per year, an inflation-adjusted equivalent amount each year thereafter, and would be exhausted after 30 years.

In other simulations, I insert one or more of the following assumptions: 1) future stock returns and inflation rates will repeat the good sequence; 2) the initial aftertax portfolio contains \$2 million, consisting of \$0.8 million in taxable accounts, \$0.2 million in Roth IRAs, and \$1 million of aftertax funds in qualified accounts; and 3) a different initial withdrawal amount.

Although the models' basic assumptions precisely fit few retirees, I am confident that the models provide a useful estimate of the sensitivity of the portfolio's longevity to alternative withdrawal strategies.

For example, if the retiree is in the 25% tax bracket and the individual beneficiary is in the 15% bracket then \$100 in a qualified account would be worth \$75 after taxes to the retiree but \$85 to the beneficiary.

If the beneficiary is a charity, then the \$100 would be worth \$75 after taxes to the retiree but \$100 to the charity. So, a retiree who plans to bequeath, say, \$100,000 to a charity should retain \$100,000 in qualified accounts and designate these assets to the charity.

Everything else the same, if the retiree has a lower tax rate than the beneficiary, she should withdraw funds from the qualified account and leave funds from the Roth IRA for the beneficiary. For example, if the retiree is in the 10% tax bracket and the individual beneficiary in the 25% bracket, then \$100 in a qualified account would be worth \$90 after taxes to the retiree but only \$75 to the beneficiary.

Conclusions

The tax-based withdrawal strategies revolve around two key principles:

First, returns are taxed more heavily in taxable accounts than retirement accounts—i.e., Roth IRAs and qualified accounts such as the 401(k). Therefore, as a rule of thumb, retirees should withdraw funds from taxable accounts before retirement accounts. Detailed models suggest that following this rule of thumb may allow a retiree's portfolio to last perhaps two to five years longer depending upon their level of wealth and tax rates. However, there are exceptions to this rule of thumb. First, before the retiree begins required minimum distributions, if her taxable income is unusually low then she should either withdraw sufficient funds from qualified accounts or convert sufficient funds from traditional IRAs to Roth IRAs to fully use low tax brackets. Second, if the retiree has substantial unrealized capital gains on assets held in taxable accounts and will await the step up in basis at death or give the appreciated asset to charity, then she should withdraw funds from retirement accounts before liquidating the appreciated asset.

The second key principle is that the investor effectively owns $(1-t)$ of

qualified accounts' principal, while the government effectively owns the remaining t of principal (where " t " is the tax rate). The objective is to minimize the government's share. To do this, the retiree should withdraw funds from qualified accounts whenever she is in a year with an unusually low tax rate. Such years are likely to occur: 1) before required minimum distributions begin; 2) in years when the retiree makes a large contribution; and 3) in years when there are large deductible medical expenses.

Finally, the relationship between the retiree's and beneficiary's tax brackets could influence the retiree's decision to withdraw funds from qualified accounts before Roth IRAs, or vice versa.

Everything else the same, if the retiree's tax bracket exceeds the beneficiary's then the retiree should withdraw funds from Roth IRAs and leave the qualified accounts' balances to the beneficiary.

If the retiree's tax bracket is lower than the beneficiary's then she should withdraw funds from qualified accounts and leave the Roth IRAs' balances to the beneficiary. ▲

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- "Retirement Savings: Choosing a Withdrawal Rate That Is Sustainable," by Philip L. Cooley, Carl M. Hubbard, and Daniel T. Walz, February 1998
- "Tax-Efficient Investing and What It Means to Your Portfolio," by William Reichenstein, February 2005
- "The Great Tax Fight: Managing Stocks in Taxable Accounts," by William Reichenstein, July 2005
- "Tax-Efficient Investing: Picking the Right Pocket for Your Assets," by William Reichenstein, November 2005

Go to www.tiaa-crefinstitute.org/research/trends/tr100106.html to access this article from the TIAA-CREF Institute:

- "Tax-Efficient Sequencing of Accounts to Tap in Retirement," by William Reichenstein, Trends and Issues, TIAA-CREF Institute, October 2006